The Tobacco Report: How divesting from tobacco affected returns over 20 years

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GENUS

FOSSIL FREE INVESTING

INTRODUCTION

Investing in tobacco is the norm in the asset management industry. Despite the harmful effect of the product, managers still include these companies in their portfolios in order to diversify, avoid sacrificing perceived performance, and collect a sizeable dividend. Even pension funds in Canada are invested in tobacco producers and manufacturers, which means that, unfortunately, all Canadians indirectly own these companies. Within our study, we investigated the merits of holding tobacco for financial performance. We researched the performance of a portfolio excluding tobacco over 20 years. We also investigated the financial results at varying levels of tobacco exclusion. Overall, we found that tobacco didn't enhance performance with any significance. Due to the trends in the tobacco industry, such as decreasing consumption and higher taxes, this lack of added value may continue.

There are a number of organizations seeking to educate the public about tobacco in their investment portfolios. Tobacco Free Portfolios recently launched the Tobacco Free Finance Pledge at the United Nations — Genus Capital and the Ontario Teachers' Pension Plan are both signatories. The World Health Organization adopted the Framework Convention on Tobacco Control (FCTC) in 2003. The treaty outlines rules governing the production, sale, distribution, advertisement, and taxation of tobacco, but not investment in it.

KEY TAKEAWAYS

- An index portfolio without tobacco didn't underperform the index with tobacco over the last 20 years
- Portfolios with very strict tobacco exclusions have outperformed the market in our 6 year study
- Tobacco is very harmful to the health of smokers, costs our economy trillions, and disproportionately hurts the most vulnerable
- There are substantial headwinds for the tobacco industry going forward – Lower cigarette consumption, global taxes, litigation

1. Mokdad AH, Marks JS, Stroup DF, Gerberding JL. Actual Causes of Death in the United States. JAMA: Journal of the American Medical Association 2004;291(10):1238–45 [cited 2017 Apr 20].
2. U.S. Department of Health and Human Services.The Health Consequences of Smoking—50 Years of Progress: A Report of the Surgeon General. Atlanta: U.S. Department of Health and Human Services, Centers for Disease Control and Prevention, National Center for Chronic Disease Prevention
3. https://www.health.harvard.edu/newsletter_article/light-and-social-smoking-carry-cardiovascular-risks

ETHICS OF TOBACCO

There are strong ethical arguments for avoiding involvement and investment in the tobacco industry. Tobacco products are harmful even in moderation and, on a greater scale, these negative externalities are costing society billions. Many of the people most harmed by tobacco are the society's most vulnerable, such as lower income individuals. On top of these negative health and monetary effects, the tobacco industry supply chain is known for human rights abuses, including child labor. Of the industries to avoid for ethical reasons, tobacco is one of the top.

In the U.S., smoking causes more deaths each year than car accidents, gun-related incidents, illegal drug use, alcohol use, and HIV combined[1]. It is the cause of almost one in five deaths[2]. Smoking harms almost all organs in the body and smokers are 2-4 times more at risk for heart disease, 2-4 times more at risk for stroke, and 25 times more at risk for lung cancer. Other types of cancer, cardiovascular diseases, respiratory diseases, diabetes, bone issues, and many other diseases are far more likely to develop in people that smoke[1].

These harmful effects don't only occur to people that are heavy smokers. Tobacco, unlike many other substances, has no safe level of usage. Light smoking is better than heavy smoking but there are still the same risks[3]. Tobacco is a product that is never harmless for consumers.

Out of all products, tobacco is the one we would hope is not addictive; however, nicotine in a cigarette will give a smoker a slight boost of dopamine, reinforcing the behavior for the future. Nicotine is absorbed quickly into the bloodstream and gives the smoker the positive effects within seconds[4]. Even though the majority of smokers in the US say that they would like to quit, only 6% are able to quit annually[5].

4. Hukkanen J, Jacob P, Benowitz NL. Metabolism and disposition kinetics of nicotine. Pharmacol Rev. 2005;57(1):79-115.doi:10.1124/pr.57.1.3.
5. Centers for Disease Control and Prevention (CDC). Quitting smoking among adults—United States, 2001-2010. MMWR Morb Mortal Wkly Rep. 2011;60(44):1513-1519.

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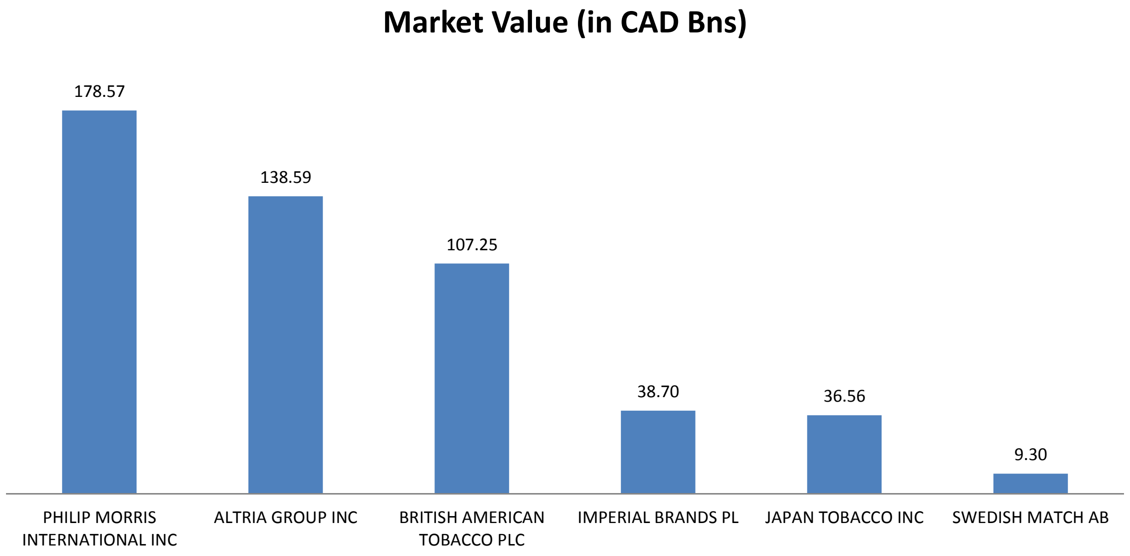
Negative impacts to users and second hand users aside, the damages of tobacco cost $1 trillion USD globally every year, almost four times higher than the taxes paid by tobacco companies annually[6]. This massive negative externality is being paid for in tax dollars, higher health insurance premiums, and out-of-pocket expenses around the world. As a result, governments and individuals have pursued lawsuits against the tobacco companies but settlements have only been a fraction of the overall costs. One of the largest settlements occurred in 1998 when 46 U.S. states sued a group of tobacco companies for health related costs. The states were awarded $206 billion over 25 years[7].

Tobacco use in developing countries has been on the decline for decades but people in low-and-middle income countries have maintained much of the global demand. Over 80% of smokers today live in low-to-middle income countries so the vast majority of future tobacco related deaths will likely occur in these countries. This burden will only increase the wealth differences between the rich and poor, as health issues can contribute to lower income and higher medical expenses[6].

The supply chain for the tobacco industry has also been detrimental to some of the most vulnerable groups. Child labor is commonplace in tobacco growing communities[8], especially in some low-income countries such as Malawi. Children face exposure to hazardous chemicals, work long hours, suffer workplace injuries, and may lack water and sanitation facilities[9 10]. These same conditions occur for adults but it is especially detrimental to children due to their stage of physical development. Pay is also often very low for children, making them quite profitable for employers.

6. U.S. National Cancer Institute and World Health Organization. The Economics of Tobacco and Tobacco Control. National Cancer Institute Tobacco Control Monograph 21. NIH Publication No. 16-CA-8029A. Bethesda, MD: U.S. Department of Health and Human Services, National Institutes of Health, National Cancer Institute; and Geneva, CH: World Health Organization; 2016.

7. https://web.archive.org/web/20080625084126/http://www.naag.org/backpages/naag/tobacco/msa/msa-pdf/1109185724_1032468605_cigmsa.pdf



Source: MSCI Data

TOBACCO INDUSTRY

Although tobacco consumers and the workers supplying the product have been harmed, tobacco has remained a huge industry for decades. The current market value of all the tobacco companies in the MSCI World Index is $508 billion (CAD), which doesn't include Chinese tobacco companies.

Not only has the industry had size on its side, it has also held onto steep profit operating margins due to branding and low supply chain costs. In 2017, operating margins were over 32% in the industry on average[11].

A company selling an addictive, high-margin product, in a large and established industry, with barriers to entry due to a strong brand, would typically be the ideal investment. Therefore, it isn't difficult to figure out why it has remained in portfolios for decades. However, the industry is changing, tobacco brands don't hold the clout they once did, and a growing number of investors aren't willing to hold a company producing large negative externalities.

8. Report from the Governing Body 329th Session in Geneva March 2017 ('ILO cooperation with the tobacco industry in the pursuit of the Organization's social mandate')
9. Human Rights Watch, Tobacco's hidden children: Hazardous child labor in the United States tobacco farming (New York: Human Rights Watch, 2014).
10. N. Doytch, N. Thelen, and R. U. Mendoza, "The impact of FDI on child labor: Insights from an empirical analysis of sectoral FDI data and case studies," Children and Youth Services Review47 (2014), pp. 157–167.
11. Factset data

GENUS RESEARCH

Genus has studied the 20-year performance of portfolios excluding the tobacco industry in order to determine whether returns are significantly different from the benchmark when tobacco is removed. We have also backtested portfolio performance within the past 7 years, when companies are excluded based on certain levels of revenue derived from tobacco products. Within both studies, there is no outperformance for a portfolio including tobacco. In addition, an optimized portfolio without tobacco tends to outperform the benchmark.

GENUS LONG-TERM STUDY

June 1998 - Sept 2018

The objective of the study was to determine the performance of an index portfolio if we removed all companies in the tobacco industry.

METHODOLOGY

- Genus defines "tobacco free" as excluding the Tobacco sub-industry from the respective indices.
- Tobacco Free "Naïve": The strategy research and backtest simply excludes the Tobacco sub-industry from the respective indexes; and reweights the remaining stocks proportionally.
- Tobacco Free Optimized: In the long-term backtest we took the Tobacco Free Naïve strategy and performed a quarterly optimization to minimize the tracking error of the portfolio against the benchmark.

- Our study focuses on a hypothetical equity portfolio that starts across all developed equity markets, focusing on a “Blended Portfolio (35% allocation to Canadian stocks and a 65% allocation to stocks in the MSCI World Index) to mirror the composition of the Genus Fossil Free CanGlobe Equity Fund and a portfolio with just the MSCI World Index.

RESULTS

The performance of a tobacco-free portfolio, whether naïve or optimized, is not different from the benchmark performance, when considering statistical significance. This means that a portfolio with tobacco would not have outperformed a tobacco free portfolio over the last 20 years. The tobacco free naïve portfolio does slightly underperform over the 20 year period by -0.06% annually for both the blended and MSCI World benchmarks, but this is so small as to not be statistically significant. When optimizing the portfolio, by substituting tobacco with other industries that are highly correlated to tobacco each quarter, active returns are slightly positive (although still not significantly greater than 0). Therefore, there is no evidence that tobacco has added any additional performance to the index.

Since Canada hasn’t had a large tobacco industry historically, the blended tobacco free naïve portfolio has a smaller tracking error than the MSCI World tobacco free naïve portfolio. Both tracking errors show that a tobacco free portfolio doesn’t deviate far from the benchmark.

June 30, 1998 - Sept 30, 2018		Only Screening Tobacco Sub-Industry			
		Annualized Return	**Active Return**	**Information Ratio**	**Tracking Error**
Blended (CAD)	Benchmark	7.89%			
Blended (CAD)	Naïve	7.84%	-0.06%	- 0.40	0.14%
Blended (CAD)	Optimized	8.03%	0.14%	0.41	0.35%
MSCI World (USD)	Benchmark	7.24%			
MSCI World (USD)	Naïve	7.18%	-0.06%	- 0.28	0.20%
MSCI World (USD)	Optimized	7.28%	0.04%	0.11	0.35%

GENUS SIX YEAR STUDY

January 31, 2012 – September 30, 2018

The objective of the study was to determine the performance of an index portfolio based on how an investor excludes tobacco.

When an investor decides to remove companies involved in a controversial product, the investor needs to determine the criteria for exclusion. One common method to exclude companies involved with a certain product is to determine the portion of the company's revenue that comes from the product and then exclude companies with revenue from the product over a certain threshold. For example, an investor that doesn't want to invest in tobacco companies could screen out companies with over 10% of revenue coming from tobacco. This will exclude companies with tobacco as their sole business but it may not exclude companies such as grocery stores that sell tobacco products, among others, at their retail locations.

The following table displays performance and tracking errors for naïve and optimized portfolios based on the MSCI World index when excluding companies at different levels of tobacco involvement.

Jan 31, 2012- Sept 30, 2018 USD

Max Rev in Tobacco	Index	Portfolio	Annualized Return	Active Return	Information Ratio	Tracking Error
	MSCI World	Benchmark	11.74%			
10%	MSCI World	Naïve	11.77%	0.04%	0.18	0.20%
10%	MSCI World	Optim	11.82%	0.08%	0.26	0.32%
5%	MSCI World	Naïve	11.77%	0.03%	0.17	0.20%
5%	MSCI World	Optim	11.81%	0.07%	0.22	0.33%
1%	MSCI World	Naïve	11.78%	0.04%	0.18	0.22%
1%	MSCI World	Optim	11.83%	0.09%	0.28	0.32%
0%	MSCI World	Naïve	11.93%	0.19%	0.55	0.35%
0%	MSCI World	Optim	11.88%	0.14%	0.39	0.37%

In this backtest over 6 years, the tobacco excluded portfolios, at all levels of exclusion, outperformed the benchmark. The greatest outperformance occurred in the portfolios with no tobacco revenue at all. The 0% revenue threshold naïve portfolio had an active return of 0.19% annualized and the 0% revenue threshold optimized portfolio had an active return of 0.14% annualized.

Information ratios were also high due to the relatively low tracking errors of the tobacco excluded portfolios.

Overall, the results show that over the past six years, performance of a tobacco excluded portfolio does not underperform the index performance even at different levels of exclusion. Moreover, portfolios outperformed when tobacco involvement was very low.

FUTURE OF THE TOBACCO INDUSTRY

Investing in tobacco would not have boosted your portfolios performance in the past but will this continue into the future? Factors around the world are showing us that tobacco will have a difficult time outpacing the market in the future too. Companies that hurt people or the environment face many financial risks, such as a backlash from consumers, higher taxes, litigation, and regulation.

Smoking has been declining in the US and other developed markets for decades and smoking among teenagers has hit record lows[12]. By 2025, the WHO predicts that Canadian smoking rates will fall under 10% down from 14.3% in 2015 and 27.5% in 2000[13]. Predicted declines are similar for many other developed countries, including the US. Almost 30% of teenagers reported to smoking cigarettes in 2000 but in 2016 only 20% were using tobacco related products, including 8% that smoked cigarettes[12]. Some attribute the decline in smoking to anti-smoking campaigns and other to changes is desired lifestyle.

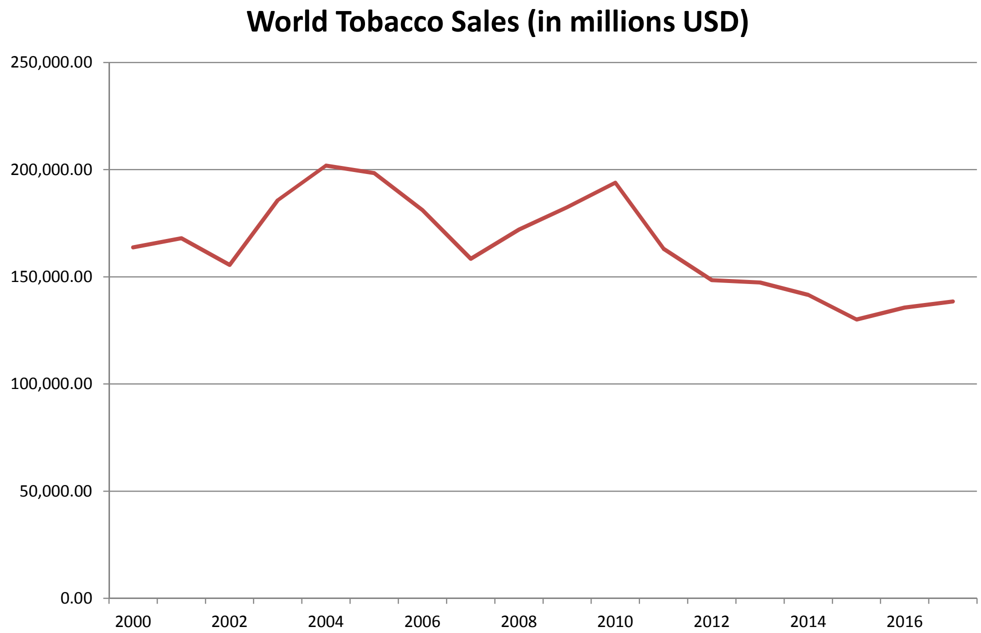
Smoking in many developing countries is still high and many countries are seeing an increased demand. As stated earlier, it is many of the most vulnerable groups that are most affected by tobacco. However, on a worldwide basis tobacco sales are on a decline.

It isn't only the decline in demand that could hurt the tobacco industry moving forward. Litigation will continue to be a large concern for the industry as governments and individuals continue to carry on legal action. Governments, including the provinces of Canada, are trying to claw back the health care costs they incurred due to the damage created by tobacco[14].

Raising taxes is the most effective policy to reduce tobacco usage and this fact poses a substantial hurdle for big tobacco companies. Studies show that a 10% increase in taxes with lower consumption by 4% on average in high income countries and 5% on average in middle to low income countries. Countries around the world have been using this tactic for years and it is only becoming more constricting for the tobacco industry. Cigarette prices in the US have increased almost 350% from 1990 to 2014, largely due to taxes. Seven countries have raised taxes to over 75% of the retail price in recent years. For lower income countries, the tax not only drives additional revenue but it is also cost-effective to implement[15].

In the future, taxes are likely to continue with the trend. Surveys show that non-smokers, and even many smokers, support further tax increases. 75% of non-smokers and 33% of smokers supported a 20% increase in taxes[15].

Overall, the tobacco industry will face strong headwinds in the future. Lower consumption, more litigation, and increased taxes are all highly probable for the next few decades.



Source: Factset Data

CONCLUSION

Tobacco doesn't have to be the norm for the asset management industry. Investors know about the harmful effects of the product and the industry as a whole. Many can also see the bleak future outlook for the industry. After our study on performance, we can now see that tobacco hasn't been adding real value to portfolios for the past 20 years. There may even be an upside to excluding tobacco, especially if screens are very strict.

Due to our ethical convictions and the research showing no hindrance to performance, Genus became a signatory to the Tobacco Free Finance Pledge in January 2019 and is now a tobacco-free wealth management firm. In our funds, we will not own tobacco manufacturers or producers, or companies that own a majority stake in tobacco manufacturers or producers.

12. Jamal A, Gentzke A, Hu SS, et al. Tobacco Use Among Middle and High School Students — United States, 2011–2016. MMWR Morb Mortal Wkly Rep 2017;66:597–603. DOI: http://dx.doi.org/10.15585/mmwr.mm6623a1.
13. WHO global report on trends in prevalence of tobacco smoking 2015
14. https://www.theglobeandmail.com/canada/article-theres-a-big-legal-battle-between-the-provinces-and-the-tobacco/
15. WHO report on the global tobacco epidemic, 2015: raising taxes on tobacco.

ABOUT GENUS CAPITAL

Genus Capital Management Inc., Canada's fossil free investment leader, was founded in 1989 and is an independent investment management firm based in Vancouver. We are passionate about creating innovative investment solutions that meet our clients' changing needs. With more than $1.5 billion in assets under management, our clients include leading environmental organizations, foundations and individuals across Canada.

As the world took notice of climate changes environmental impact, our clients, such as the David Suzuki Foundation, began to see its impending economic impact, and asked to collaborate on a socially responsible investment portfolio. In 2013 we enhanced our socially responsible strategies and created Genus Fossil Free to better align the values of our clients with their investments and help address some of the world's pressing socioeconomic and environmental challenges. Today, Genus Capital is at the forefront of Canada's Divest-Invest movement with a complete suite of fossil fuel free funds that are tailored to meet the needs of investors who wish to divest from the world's worst polluters and invest in a sustainable, clean energy future.

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